F&V Capital Management, LLC
2300 Glades Road, Suite 220W
Boca Raton, FL 33431

H. Terrence Riley III, CFA
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Contact: Karin Mueller-Paris
+1-561-208-1081 kmm@fvcm.us

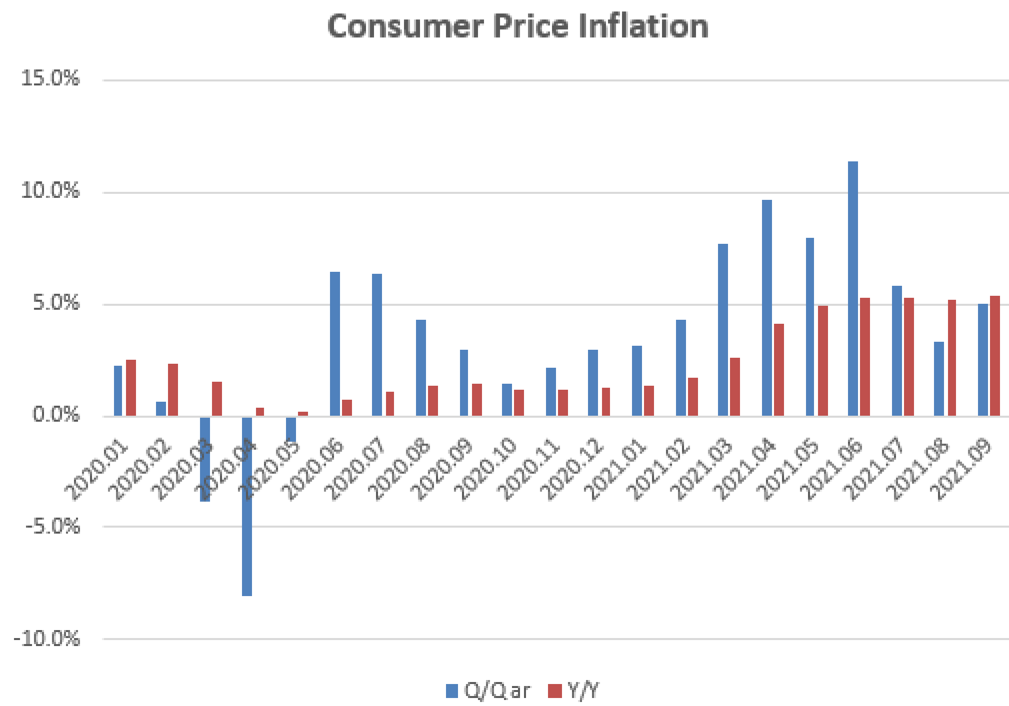
S&P 500

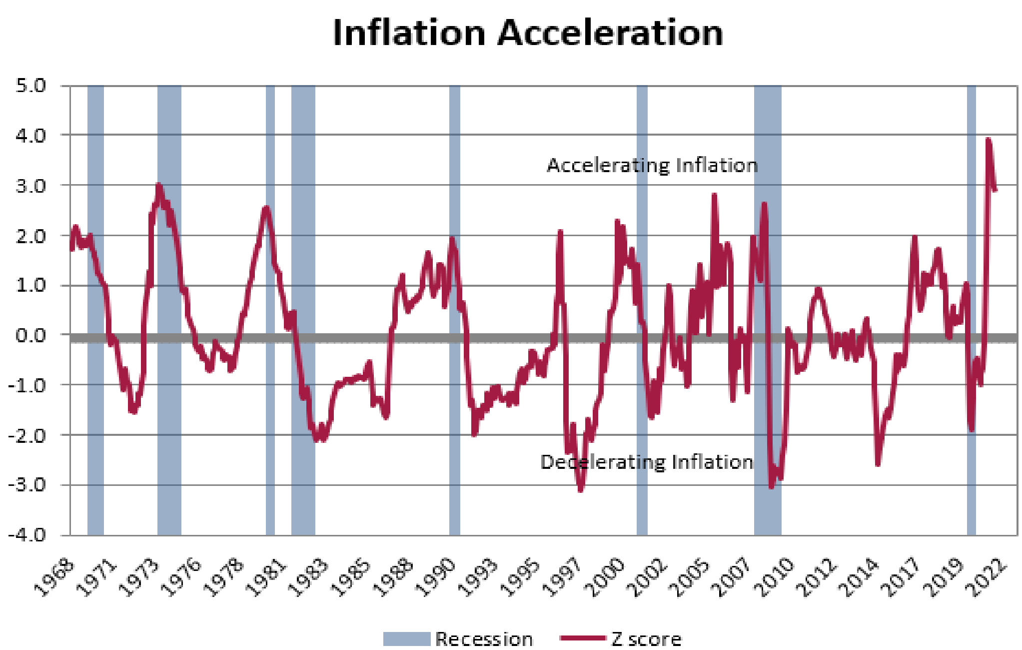
After the uber strong returns during the first eight months of the year, the S&P 500 has unsurprisingly drifted lower in September and October. Technical indicators are not oversold (14 day RSI = 45) and it would not be shocking to see the index test the 200 day average at about 4200. Basic market fundamentals like higher earnings and the prospect that the economy will continue to expand through 2022 and likely in 2023, are giving stock prices an upward bias. But concerns about inflation, and especially rising energy prices, are a major factor in the recent market weakness. It also explains why value and cyclical stocks have recently started to outperform large cap growth stocks again. Nonetheless, there are still good arguments why inflation will eventually lessen. The current downdraft in stock prices will most likely prove to be a buying opportunity.

INFLATION

The U.S. consumer price index for September was just reported this morning, up 0.4% m/m. That's still a very high 5.4% y/y but there are signs that inflation has hit its peak. The z-score, which a sort of second derivative measure (see second chart), has peaked and is now suggesting that inflation is decelerating. Our proprietary model, as discussed in the July report, still shows underlying inflation pressure at about the 2%

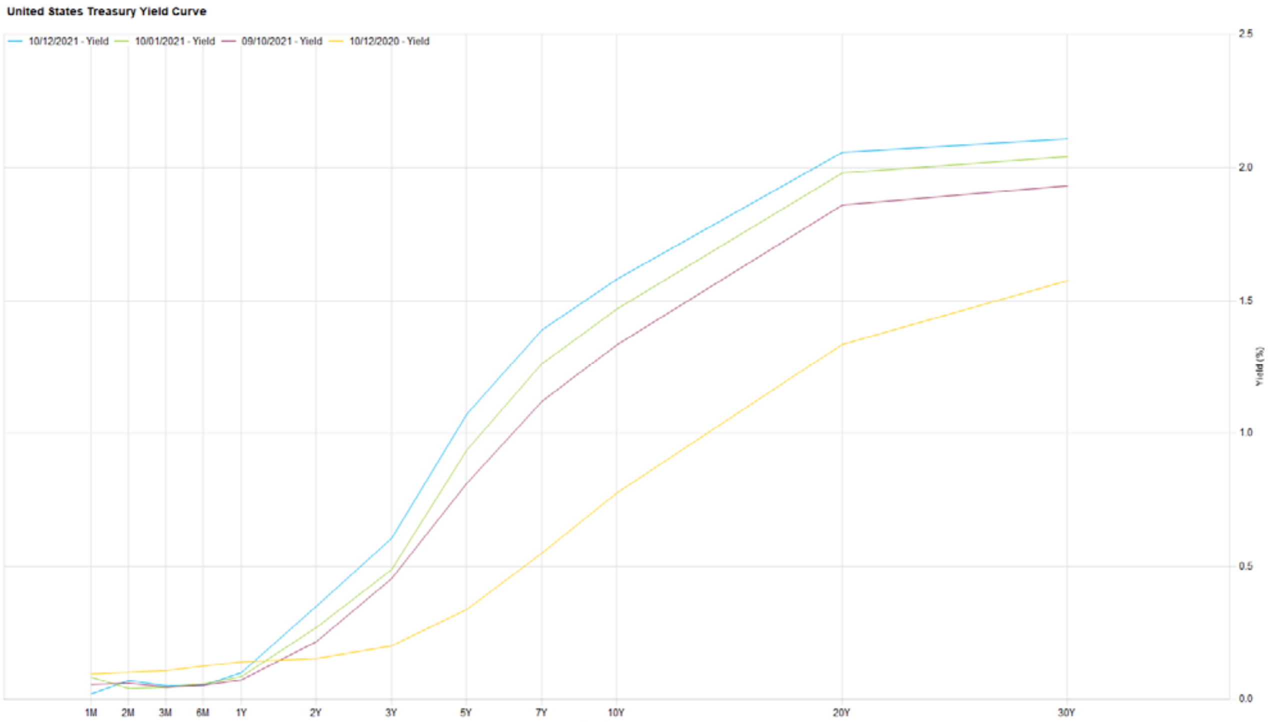
level.   Bottom line is that inflation figures will likely remain ugly for some months more, but in a year or two from now we may be more worried about recession and disinflation again.





CENTRAL BANKS

It is clear that the central banks will be reducing asset purchases possibly this year, and certainly next year.   It is also quite possible that short term interest rate targets will be increased in 2022. The inflation statistics will make this a near certainty.   Stock prices historically have risen as the Fed began a tightening process—stock prices rise at the same time interest rates rise. The peak in stock prices typically doesn't occur until later in the process when long term interest rates stop rising and the yield curve flattens. That is the point where investors become alarmed about recession and a coming peak in corporate profits. But see below. The yield curve has been steepening. This data would suggest that we are not near recession or a peak in profits and is bullish for equities.



CHINA

China is important for two reasons: 1. Economic integration with the U.S. and as a primary supply center of many manufactured goods; 2. Because of its geopolitical risk and magnitude.

The U.S. is likely to very soon delist nearly all Chinese stocks from the U.S. stock exchanges because of the Chinese refusal to allow transparent accounting audits as is done in the U.S. and Germany. Combined with the collapse in dollar bonds issued by Chinese building companies, it is a near certainty that the U.S. and China will become divorced from a capital markets perspective. I am very bearish in this regard and ultimately, I expect lawsuits in the U.S. against the firms (Goldman Sachs, Morgan Stanley, et. al.) who directed investor capital to China knowing it is a Communist country whose laws are arbitrary and capricious. Also, U.S. corporations will accelerate a shift in manufacturing away from China and into alternative nations where sufficient labor can be found. This will take years and be difficult.

My largest concern about China at this point is the growing tensions with Taiwan. This will be compounded if the Chinese economy enters a period of instability and contraction due to the collapse of the real estate bubble there, rising commodity prices, and the misallocation of capital and resources via its central command economy. Xi Jinping, who wants to be dictator for life like Mao, will likely enhance efforts to stir patriotic movements in order to suppress discontent from economic malaise. Typically, geopolitical risks cause short term disruptions lasting months and not years to equity markets. Nonetheless, this is a risk factor that cannot be ignored.

SUMMARY

Data suggests that U.S. economy and corporate profits will remain in an expansion mode through 2022. Stock prices can continue to modestly rise (single digits) as earnings continue to grow at a doubledigit pace and P/E ratios contract. Bond yields are likely to rise and long bonds should be avoided for now. As has been the case over the past 50 plus years, there are always known risks and unknown risks that can cause market volatility over short periods.

Longer term, when the yield curve begins to flatten and risks are increasing, especially if high frequency data like the ISM Manufacturing Index indicates contraction, it will be time to shift capital away from equities and into long term U.S. Treasury bonds. It is difficult to know when this will happen (perhaps not until 2023 or later).
